Brownstein
Farber | Sc

000012424O

ORIGINAL

Jeffrey W. Crockett
Attorney at Law
602.382.4062 tel
602.382.4020 fax
jcrockett@bhfs.com

March 30, 2011

Docket Control Center
Arizona Corporation Commission
1200 West Washington Street
Phoenix, Arizona 85007-2927

RE: In the Matter of the Commission's Generic Evaluation of the Regulatory Impacts from the Use of Non-Traditional Financing Arrangements by Water Utilities and their Affiliates (Docket W-00000C-06-0149)

Ladies and Gentlemen:

As requested by Utilities Division Staff, I am filing a copy of the Power Point presentation and white paper presented on behalf of Johnson Utilities LLC at the Commission's workshop on March 25, 2011.

Sincerely,

Jeff Crockett

Jeffrey W. Crockett

JWC:jp

Original + 13 copies filed with
Docket Control

14676\3\1520278.1

Arizona Corporation Commission
DOCKETED
APR - 1 2011

DOCKETED BY	

RECEIVED
2011 APR - 1 P 4: 53
AZ CORP COMMISSION
DOCKET CONTROL

Brownstein | Hyatt
Farber | Schreck

Imputed Income Tax Expense for S-Corporations and Limited Liability Companies

ACC Workshop
Docket W-00000C-06-0149

Presented by
Jeffrey W. Crockett
March 25, 2011

Always

Rate-Setting Principles

- The Commission has a constitutional mandate to set rates and charges for public utilities which are "just and reasonable." *Arizona Constitution, Article 15, Section 3*.
- When setting rates, the Commission should ensure that "total revenue, including income from rates and charges, should be sufficient to meet a utility's operating costs and to give the utility and its stockholders a reasonable rate of return on the utility's investment." *Scates v. Arizona Corporation Commission*.
- Rate setting should be applied in a manner which produces reasonable and equitable results without regard to the legal form of the utility.

Pass-Through Entities and Income Tax Expense

- Income taxes, while due from the members/shareholders of limited liability companies and S-corporations, are directly attributable to the taxable income generated by the utility.
- The income of LLCs and S-Corps is taxed at the member/shareholder level whether or not any income is distributed to the member/shareholder.

Pass-Through Entities and Income Tax Expense

- Under the Commission's current approach to income tax expense, a 10% authorized return for an LLC or S-Corp is not equivalent to a 10% authorized return for a C-Corp. The LLC and S-Corp return is <u>before</u> tax whereas the C-Corp return is <u>after</u> tax.
- By failing to impute income tax expense, LLCs and S-Corps have a lower revenue requirement than C-Corps, which results in rates that are not "just and reasonable."
- Rate payers receive a windfall from the lower revenue requirement and operating income when income tax expense is excluded.

LLCs and S-Corps are Analogous to a C-Corp subsidiary in a Public Utility Holding Company

- LLCs and S-Corps should be treated in the same way as a subsidiary C-Corp in a public utility holding company.
- A subsidiary C-Corp does not itself pay taxes or file a separate tax return, but the revenues and losses of the C-Corp (as well as any other affiliates) are consolidated at the holding company level and taxes are paid by the holding company.

LLCs and S-Corps are Analogous to a C-Corp subsidiary in a Public Utility Holding Company (Cont'd)

- In the case of a C-Corp utility subsidiary of a public utility holding company, the Commission has traditionally allowed income taxes to be computed on a stand-alone basis for the utility and included in its revenue requirement.
- Inclusion or exclusion of income taxes should not turn on technical distinctions, but rather on principles of fairness and non-discrimination.
- There is no good basis in public policy to treat LLCs and S-Corps differently that a C-Corp subsidiary of a public utility holding company.

A Pass-Through Entity is an Advantageous Corporate Form for Start-Up Utilities

- With an LLC or S-Corp, the owners of a utility can take immediate advantage of tax losses.
- Given that the owners of a new utility typically subsidize the utility in the early years, this tax advantage is particularly important because it reduces the amount of the cash subsidy at a time when the cash demands of the utility are generally highest.

A Pass-Through Entity is an Advantageous Corporate Form for Start-Up Utilities (Cont'd)

- The ability to take immediate advantage of tax losses also helps a new utility attract additional capital from its owners. This helps level the playing field between larger, established C-Corps and typically smaller LLCs and S-Corps.
- The pass-through form of incorporation increases the odds of a healthier start-up utility, which serves the public interest.
- Rate payers are not disadvantaged by the inclusion of income tax expense for LLCs and S-Corps.

Income Tax Expense for Pass-Through Entities will be no Higher than Income Tax Expense for C-Corps

- The Commission can easily ensure that rate payers of LLCs and S-Corps do not pay higher tax expense than rate payers of C-Corps.
- The allowable income tax expense for an LLC or S-Corp would be the lesser of:
  - the tax expense of the owners/shareholders at their individual tax rate (assuming the sole source of income is from the utility); or
  - the tax expense assuming the LLC or S-Corp is a C-Corp.
- Hypothetical income tax calculations are frequently used by the Commission for C-Corps.

Brownstein | Hyatt
Farber | Schreck

Analysis of Impacts of Income Taxes

Analysis of Impacts of Income Taxes

Companies are assumed to be the same in every respect except for recovery of income taxes.

	Utility as a C-Corp	Utility as a S-Corp	Utility as a Sole Proprietorship LLC*, or Partnership
Rate Base	$ 1,200,000	$ 1,200,000	$ 1,200,000
Rate of Return (ROR)	10.00%	10.00%	10.00%
Required Operating Income	$ 120,000	$ 120,000	$ 120,000
Revenues	$ 345,440	$ 270,000	$ 270,000
Less: Allowed Operating Expenses	100,000	100,000	100,000
Depreciation	50,000	50,000	50,000
Income Taxes (assumes 38.6% state and federal effective tax rate)	75,440	-	-
Operating Income	$ 120,000	$ 120,000	$ 120,000
Earnings before Interest, Taxes, and Depreciation and Amortization (EBITDA)[1]	$ 245,440	$ 170,000	$ 170,000
Earnings before Interest and Taxes (EBIT)[2]	$ 195,440	$ 120,000	$ 120,000
Implied Value (assuming capitalization rate[3] for EBITDA is 14.5%)	$ 1,692,690	$ 1,172,415	$ 1,172,415
Implied Value (assuming capitalization rate[3] for EBIT is 11.5%)	$ 1,699,478	$ 1,043,480	$ 1,043,480
From Shareholder/Sole Proprietor/LLC Member/Partner View (assumes no reimbursement from Company for income taxes)			
Dividend/Distribution (assume 50% payout of earnings after taxes)	$ 60,000	$ 60,000	$ 60,000
Less: Dividend Tax (assume qualified dividend tax rate of 15%)	(9,000)	-	-
Less: Personal Income Taxes (assume 35% state and federal effective tax rate)[6]		(42,000)[6]	(42,000)[6]
Less: Self-employment Taxes (for sole proprietorship, LLC, and partnership)[7]			(16,723)[7]
Net CashFlow to Shareholder/Sole Proprietor/LLC Member/Partner	$ 51,000	$ 18,000	$ 1,277
Investor's net cash yield on investment[7]	4.25%	1.50%	0.11%
Difference in cash flow compared to C-Corp shareholder without reimbursement		$ (33,000)	$ (49,723)
From Shareholder/Sole Proprietor/LLC Member/Partner View (assumes a reimbursement from Company for income taxes)			
Dividend/Distribution (assume 50% payout of earnings after taxes)	$ 60,000	$ 60,000	$ 60,000
Less: Dividend Tax (assume qualified dividend tax rate of 15%)	(9,000)	-	-
Less: Personal Income Taxes (assume 35% state and federal effective tax rate)[6]		(42,000)[6]	(42,000)[6]
Less: Self-employment Taxes (for sole proprietorship, LLC, and partnership)[7]			(16,723)[7]
Plus: Reimbursement from Company for Income Taxes		42,000	42,000
Net CashFlow to Shareholder/Sole Proprietor/LLC Member/Partner	$ 51,000	$ 60,000	$ 43,277
Investor's net cash yield on investment[7]	4.25%	5.00%	3.61%
Difference in cash flow compared to C-Corp shareholder with reimbursement		$ 9,000	$ (7,723)
From Company's View (assumes Company reimburses for income taxes)			
Cash Flow to Company (Income after tax plus depreciation)	$ 170,000	$ 170,000	$ 170,000
Less: Dividend/Distribution (assume 50% payout of earnings after taxes)	(60,000)	(60,000)	(60,000)
Less: Payments to Owners for Income Taxes	-	(42,000)	(42,000)
Net Cash Flow to Company (that may be used for reinvestment)	$ 110,000	$ 68,000	$ 68,000
Difference to Company net cash flow compared to C-Corp with reimbursement		$ (42,000)	$ (42,000)
Company's net cash yield on investment[8]	9.17%	5.67%	5.67%

* Limited Liability Company (LLC) which elects to be treated as a partnership for tax purposes.

[1] EBITDA is essentially net income with interest, taxes, depreciation, and amortization added back to it, and can be used to analyze and compare profitability between companies and industries because it eliminates the effects of financing and accounting decisions.

[2] EBIT is *all profits before taking into account interest payments and income taxes.* An important factor contributing to the widespread use of EBIT is the way in which it nulls the effects of the different capital structures and tax rates used by different companies. By excluding both taxes and interest expenses, the figure hones in on the company's ability to profit and thus makes for easier cross-company comparisons.

[3] Capitalization rate (c) equals the cost of capital or discount rate (k) minus the expected growth rate (g) for the benefit stream being employed. Implied Value equals Benefit stream divided by Capitalization rate.

[4] Effective income tax rate could vary depending on level of taxable income. Income taxes computed on stand-alone basis.

[5] No taxble income at entity level. S-Corp, Sole Proprietorship, LLC, and Partnership does not pay income taxes. Taxable Income is passed through to owners.

[6] Effective income tax rate could vary depending on level of taxable income. Owners pay taxes on all the income from the utility and not just on dividends/distributions received.

[7] Pass-through income is generally subject to up to 15.3% self-employment tax (12.4% for social security up to $106,800 for 2011, and 2.9% on all income) for sole proprietorship, LLC, and partnership. *For 2011, the social security* tax rate has been reduced to 10.4%.

[8] Assumes equity investment equals rate base.

<u>**The Issue of Income Tax Recovery in Rates for Tax Pass-Through Entities**</u>

<u>Introduction</u>

The Arizona Corporation Commission's ("Commission") current "policy" is to use the "stand alone" method for computing income taxes for inclusion on the cost of service for Subchapter C Corporations ("C-Corp."). The "stand-alone" method is used irrespective of whether the utility files a separate individual tax return or its income is included on the consolidated return of a parent company. However, it is also the Commissions current "policy" is to <u>exclude income taxes</u> from the determination of the revenue requirement for utilities which are tax-pass through entities such as sole proprietorships, partnerships, limited liability companies ("LLC"), and Subchapter S corporations ("S-Corp"). This paper, prepared by Thomas J. Bourassa, CPA, provides a background on the "stand-alone" method's application and use, the basis for its use in ratemaking, and the merits of the inclusion of income taxes in the cost of service for tax-pass through entities.

<u>Background</u>

Most states use the "stand-alone" method for computing income taxes. This method calculates taxes based upon regulated revenues and operating costs of the utility itself without regard to the utility's unregulated revenues and operating costs of the utility or its parent and other affiliated companies. The "stand alone" calculation is used so that taxes in utility rates are based upon the costs of providing service.[1]

[1] Federal and State tax laws allow a corporate holding company to file consolidated tax returns reflecting all of its regulated and unregulated operations. On the consolidated return losses in some corporate operations can offset profits in other corporate operations for the purposes of determining the corporate income tax liability. Consolidated tax reporting can result in amounts collected for income taxes in a utility's rates exceeding the income taxes that a parent actually pays.

The rationale for computing income taxes on a "stand-alone" basis for ratemaking is at least three-fold.[2] First, this approach avoids cross-subsidization of rate payers between the utility and non-utility operations.[3] Second, the "stand-alone" method treats income taxes in the same manner as most other utility revenues and expenses. That is, both revenues and expenses are estimated and not trued-up in later rate cases. Third, this method is consistent with standard ratemaking principles. As explained in *Accounting for Public Utilities* published by Mathew Bender and Company:

> The only approach that is consistent with standard ratemaking principles is to put the regulated utility on a stand-alone basis and to assign the full tax burden to the taxable gain source and a tax benefit to the tax loss source. The basic theory is that the regulated costs should not be affect by the results from non-regulated operations.[4]
>
> [C]onsistent with a fundamental principle of the cost of service approach to ratemaking; the principle that consumers should bear only the costs for which they are responsible. Under this principle, there is a well-reasoned, and widely recognized, postulate that ***taxes follow the events they give rise to.*** Thus if ratepayers are held responsible for costs, they are entitled to the tax benefits associated with the costs. If ratepayers do not bear the costs, they are not entitled to the tax benefits associated with the costs.[5] (***emphasis added***)

The major criticism of the "stand-alone" method is that there are potentially significant differences each year between income taxes in the rates the customer pays and what the utility or its parent pays in income taxes. Determining a utility's revenue

[2] A fourth reason to use the "stand-alone" method is that the Internal Revenue Service requires the use of normalization accounting for computing income taxes for ratemaking. Violating that requirement would result in the loss of benefits to utilities and their customers from accelerated depreciation deductions for tax filings.

[3] Standard ratemaking principles prohibit cross-subsidization between the utility and non-utility operations. Further, including the effect of non-utility operations in utility tax calculations for ratemaking could be determined to result in confiscatory and unlawful rates.

[4] Deloitte & Touche LLP, et al. *Accounting for Public Utilities*. Lexus-Nexis (Mathew-Bender & Co.) 2009, Sec. 7.08[3] ("Deloitte & Touche").

[5] *Id.* at Sec. 17.05[3].

requirement, the established rates are set to provide the utility a reasonable opportunity – not a guarantee – to recover its reasonable costs of providing service and earn its authorized rate of return on investments. In other words, rates are based upon estimates of what costs the utility will incur to provide service when new rates are in effect. Actual revenues and expenses may turn out to be different than the levels estimated during the setting of rates. However, it may be several years before the utility files for new rates to reflect new levels of revenues and expenses and it is assumed that the changing expenses and revenues will balance out between rate cases. With rare exception, rates are not adjusted retrospectively to true-up for the revenues and costs actually incurred.

State commissions vary as to whether income taxes for pass-through entities are allowed in cost of service. Jurisdictions in which public service commission have disallowed income tax recovery in the cost of service (rates) for tax pass-through entities include Florida,[6] Indiana,[7] Kentucky,[8] Vermont,[9] and Wisconsin[10]. However, jurisdictions in which income tax recovery has been allowed include California,[11] Kansas,[12] Michigan,[13] New Jersey,[14] New Mexico,[15] South Carolina,[16] Texas,[17]

[6] *See for example*: *In Re: Proposed Revisions to Rules 25-30.020, . . ., Pertaining to Water and Wastewater Regulation*, Docket No. 911082-WS (1993 WL 590740 (Fla.P.S.C); *see also Re B& C Water Resources, L.L.C.* Docket No. 080197-WU (2008 WL 3846530 (Fla.P.S.C.); and *see also Re Anglers Cove West, Ltd.* Docket No. 070417-WS (2008 WL 3846530 (Fla.P.S.C.)).

[7] *See In re Pioneer Village Water, Inc.*, (1998 WL 999991 (Ind. U.R.C. 1998)).

[8] *See In the Matter of: An Application of Ridge-Lea Investments, Inc. for an Adjustment of Rates Pursuant to the Alternative Rate Filing Procedure for Small Utilities,* Docket 2008-00364 (2008 WL 4696006 (Ky.P.S.C.)).

[9] *See Re Shoreham Telephone Company Inc.*, Docket No. 6914 (2004 WL 2791514 (Vt.P.S.B.), 181 Vt. 57, 915 A.2d 197 (2006)); *see also Re Vermont Electric Power Company, Inc.* Docket No. 7174 (251 P.U.R.4th 331, 2006 WL 1714971 (Vt.P.S.B.)).

[10] *See Re St. Croix Valley Natural Gas, Inc., Docket* No. 5230-GR-104 (2006 WL 707437 (Wis.P.S.C.).

[11] California has included an allowance for income tax expenses as part of rates when evaluating utilities that are organized as limited partnerships. *See ARCO Products Co. v. SFPP, L.P.*, 81 CPUC2d 573 at 16 (1998).

[12] *See Re Madison Telephone, L.L.C.*, Docket No. 07—MDTT-195-AUD (2007 WL 2126360 (Kan.S.C.C.)).

Washington,[18] and again Wisconsin[19].

Rationale for Disallowing Income Taxes in Rates for Tax Pass-Through Entities

The rationale typically advanced for disallowing income tax recovery for tax pass-through utility entities is that the utility itself does not pay income taxes at the entity level. Rather, the income taxes are paid at the ownership level (the individual, partners, members, or shareholders).

Rationale for Recovery of Income Taxes for Tax Pass-through Entities

The rationale for the allowance of income tax recovery for pass through entities is that the income taxes relative to the utility's income are "just as much a cost of acquiring and operating the assets of that entity as if the utility assets were owned by a corporation."[20] In the *ExxonMobil* case, the Federal Energy Regulatory Commission

---

[13] *See Re Detroit Thermal, L.L.C.*, Case No. U-13691 (2005 WL 2230278 (Mich.P.S.C.)).

[14] *See Re Maxim Sewerage Corporation BPU*, Docket No. WR97010052 (1998 WL 223177 (N.J.B.P.U.)).

[15] The New Mexico Supreme Court found that a sole proprietorship may include income tax expenses in rate base in "an amount equal to the tax the Company would pay if incorporated" as a standard C corporation. *Moyston v. New Mexico Public Serv. Comm'n*, 63 P.U.R. 3d 522, 412 P.2d 840, 851 (1966).

[16] *See Re Madera Utilities, Inc.*, Docket No. 2003-368-S (2004 WL 1714912 (S.C.P.S.C.), *see also Re Development Services, Inc.*, Docket No. 2004-212-S (2005 WL 712315 (S.C.P.S.C.)).

[17] "The income taxes required to be paid by shareholders of a Subchapter S corporation on a utility's income are inescapable business outlays and are directly comparable with similar corporate taxes which would have been imposed if the utility operations had been carried on by a corporation." *Suburban Utility Corp. v. Public Utility Comm'n of Texas*, 652 S.W. 2d 358, 364 (1983). Accordingly, the Texas Supreme Court held that the S corporation was "entitled to a reasonable cost of service allowance for federal income taxes actually paid by its shareholders on [the company's] taxable income or for taxes it would be required to pay as a conventional corporation, whichever is less." *Id.*

[18] *See Washington Utilities and Transportation Commission v. Rainer View Water Company, Inc.*, Docket No. UW-010877 (2002 WL 31432725 (Wash.U.T.C.)).

[19] *See Re CenturyTel of the Midwest-Kendall, Inc.*, Docket No. 2815-TR-103 (2001 WL 1744202 (Wis.P.S.C.) *see also Re CenturyTel of Central Wisconsin, L.L.C.*, Docket No. 2055-TR-102 (2002WL 31970289 (Wis.P.S.C.)).

[20] *See ExxonMobil Oil Corp. v. Federal Energy Regulatory Comm'n*, 487 F.3d 945, 376 U.S.App.D.C.

("FERC") adopted a policy of full income tax allowances for limited partnerships.[21] In support of allowing income tax expense for pass-through entities, FERC found no good reason to limit the income tax allowance to corporations, given that "both partnerships and Subchapter C corporations pay income taxes on their first tier income."[22] Moreover, FERC determined that income taxes paid on the partners' distributive share of income were properly "attributable" to the regulated entity because such taxes must be paid regardless of whether the partners actually receive a cash distribution.[23] ("[I]t is axiomatic that each partner must pay taxes on his distributive share of the partnership's income without regard to whether that amount is actually distributed to him.").[24] Based on this aspect of partnership law, FERC concluded that income taxes paid by investors in a limited partnership are "first-tier" taxes that may be allocated to the regulated entity's cost-of-service.[25]

In *ExxonMobil*, the petitioners argued that these taxes are ultimately paid by individual investors-not the pipeline-and thus it was improper for FERC to allow income tax as an expense to the regulated entity. However, FERC reasonably addressed this concern, explaining:

> Because public utility income of pass-through entities is attributed directly to the owners of such entities and the owners have an actual or potential income tax liability on that income, the Commission concludes that its rationale here does not violate the court's concern that the Commission had created a tax allowance to compensate for an income tax cost that is not actually paid by the regulated utility.[26]

FERC also emphasized that "the return to the owners of pass-through entities will

---

259, (D.C. Cir. 2007)
[21] *Id.* at 952
[22] *Id.*
[23] *See United States v. Basye*, 410 U.S. 441, 453, 93 S.Ct. 1080, 35 L.Ed.2d 412 (1973).
[24] *Id.*
[25] *Id.*
[26] *See ExxonMobil.*

be reduced below that of a corporation investing in the same asset if such entities are not afforded an income tax allowance on their public utility income."[27] FERC determined that "termination of the allowance would clearly act as a disincentive for the use of the partnership format," because it would lower the returns of partnerships vis-à-vis corporations, and because it would prevent certain investors from realizing the benefits of a consolidated income tax return.[28]

As the FERC and the Courts recognized, despite the fact that a tax-pass through utility does not pay income taxes itself, in reality there is ultimately a business outlay for income taxes. Owners must report the utility's income on their returns and income taxes are ultimately paid. Rate making should be applied in a manner which produces reasonable and realistic results no matter what the legal form of the utility. Inclusion or exclusion of income taxes should not be "limited to technical distinctions, but is determined by *practical economic facts*".[29] A *practical economic fact* is that taxes must be paid regardless of the form of the entity generating the taxable income. To exclude taxes for some forms but include taxes for other creates an unfair and discriminatory result.

Impact of Disallowance of Income Taxes

By disallowing recovery of income taxes, a tax pass-through entity receives a lower revenue requirement than a C-Corp. Two utilities granted the same operating income and whose only difference is whether income taxes are allowed will have very different investment values. This has fair value implications as well as fair return implications. If the values of two similarly situated entities, receiving the same return and operating income, are not the same then there must be a "taking" of property on the

[27] *Id.*
[28] *Id.* at 952-953, 376 U.S.App.D.C. at 266-267.
[29] *Moyston v. New Mexico Public Service Commission*, 76 N.M. 146, 160; 412 P.2d 840,850 (1966).

entity with the lower value. One utility receives an after-tax return while the other receives a before-tax return. To illustrate this point, assume that two utilities (one a C-Corp and one an S-Corp) are both granted a 10% return on a rate base of $1,200,000. The C-Corp is granted recovery of income taxes and the S-Corp. is not. The situation may look something like this:

	Utility as a C-Corp	Utility as an S-Corp
Rate Base	$ 1,200,000	$ 1,200,000
Rate of Return (ROR)	10.00%	10.00%
Required Operating Income	$ 120,000	$ 120,000
Revenues	$ 345,440	$ 270,000
Less: Allowed Operating Expenses	100,000	100,000
Depreciation	50,000	50,000
Income Taxes (38.6% tax rate)	75,440	-
Operating Income	$ 120,000	$ 120,000

While both utilities receive the same operating income and return, the economic reality is the value of each utility is significantly different, exposing the fact that these two utilities are not treated the same. One way to compare two companies is to look at earnings before interest and taxes ("EBIT"). EBIT nulls the effects of different capital structures and tax rates used by different companies and hones in on the company's ability to generate profit. Using the illustration above, EBIT will be as follows:

	Utility as a C-Corp	Utility as an S-Corp
Operating Income	$ 120,000	$ 120,000
Income Taxes	$ 75,440	$ 0
EBIT	$ 195,440	$ 120,000

Since the two utilities are the same in every way, including investment risk, then applying the same capitalization rate[30] to each of the EBITs to determine investment value is appropriate. If the capitalization rate for EBIT is determined to be 11.5%, then the resulting investment values[31] for each company will be as follows:

	Utility as a C-Corp	Utility as an S-Corp
EBIT	$ 195,440	$ 120,000
Capitalization Rate	11.5%	11.5%
Implied Value	$1,699,478	$1,043,480

It really does matter what capitalization rate you use for EBIT, the investment value of an S-Corp will always be significantly less when income taxes are not allowed.[32] This is because the benefit stream (EBIT) will be significantly less for the S-Corp. Another measure of the benefit stream than can be used is earnings before interest, taxes, depreciation, and amortization ("EBITDA"). EBITDA is another measure used to compare the profitability of companies because, like EBIT, it eliminates the effects of financing and accounting decisions. Of course, the capitalization rate for EBITDA may be different than the capitalization rate for EBIT in a valuation analysis. Putting that

[30] Capitalization rate (c) equals the cost of capital or discount rate (k) minus the expected growth rate (g) for the benefit stream being employed. In the example, it is EBIT. For a discussion of Capitalization rate see Chapter 10 – Discount Rates and Capitalization Rates, *Understanding Business Valuation – A practical Guide to Valuing Businesses 2nd Edition*, Gary R. Trugman, American Institute of Certified Public Accountants, 2002.

[31] Value equals Benefit stream divided by Capitalization rate. For a discussion of Capitalization rate see Chapter 10 – Discount Rates and Capitalization Rates, *Understanding Business Valuation – A practical Guide to Valuing Businesses 2nd Edition*, Gary R. Trugman, American Institute of Certified Public Accountants, 2002.

[32] It is axiomatic in any valuation analysis that it does not really matter whether an appraiser is working with pretax or after-tax information. After-tax discount and capitalization rates must be used with after-tax benefit streams and alternatively before-tax discount and capitalization rates must be used with before-tax benefit streams. The key is to be consistent.

aside, based upon the illustration above, EBITDA for the C-Corp, like EBIT, is significantly greater than that of the S-Corp, so the C-Corp's value will also be significantly greater. Using the illustration above, EBITDA will be as follows:

	Utility as a C-Corp	Utility as an S-Corp
Operating Income	$ 120,000	$ 120,000
Depreciation	$ 50,000	$ 50,000
Income Taxes	$ 75,440	$ 0
EBITDA	$ 245,440	$ 170,000

If the capitalization rate for EBITDA is determined to be 14.5%, then the resulting investment values for each company will be as follows:

	Utility as a C-Corp	Utility as an S-Corp
EBITDA	$ 245,440	$ 170,000
Capitalization Rate	14.5%	14.5%
Implied Value	$1,692,670	$1,172,415

As one can clearly see from the discussion and illustrations above, the denial of the recovery of income taxes results in inequities and arguably creates an unfair arbitrage situation for tax pass-through entities and their investors versus C-Corps and their investors. It is not surprising then that the Internal Revenue Service ("IRS") has frequently taken the position in fair value determinations that tax pass-through entities should be tax-effected.[33]

The lower investment value makes sense for the S-Corp when income taxes are disallowed. From an investor's point of view, the investor's net return will be lower if

[33] Trugman, Gary R., *Understanding Business Valuation – A practical Guide to Valuing Businesses 2nd Edition*, American Institute of Certified Public Accountants, 2002, p. 286.

the investor bears the cost of the income taxes without reimbursement from the company. Alternatively, if the company reimburses investors for the income taxes, the company will have less cash flow from which to reinvest and grow.

The lower net return to the investor in an S-Corp assuming he/she is not reimbursed for income taxes can be illustrated. Assume the situation described earlier when both the C-Corp utility and the S-Corp utility are authorized operating incomes of $120,000. Assuming that each utility pays out 50% of earnings as a dividend and the investor is not reimbursed for income taxes, then the S-Corp investor will net $33,000 less than the C-Corp investor even after accounting for the dividend tax that the C-Corp investor will pay. This is shown as follows:

From Shareholder's View (assumes no reimbursement from Company for income taxes)	Utility as a C-Corp	Utility as an S-Corp
Dividend (assume 50% payout of earnings after taxes)	$ 60,000	$ 60,000
Less: Dividend Tax (assume qualified dividend tax rate of 15%)	(9,000)	
Less: Personal Income Taxes (assume 35% state and federal effective tax rate)		(42,000)
Net Cash Flow to Shareholders	$ 51,000	$ 18,000

If the investor in an S-Corp is reimbursed for income taxes he/she appears to be better off than the C-Corp investor. This is shown as follows:

From Shareholder's View (assumes reimbursement from Company for income taxes)	Utility as a C-Corp	Utility as an S-Corp
Dividend (assume 50% payout of earnings after taxes)	$ 60,000	$ 60,000
Less: Dividend Tax (assume qualified dividend tax rate of 15%)	(9,000)	
Less: Personal Income Taxes (assume 35% state and federal effective tax rate)		(42,000)
Plus: Reimbursement for income taxes		42,000
Net Cash Flow to Shareholders	$ 51,000	$ 60,000

The investors in a C-Corp net $51,000 while those in and S-Corp. net $60,000 – or

$9,000 more. However, the S-Corp itself (in which the investors hold a stake) nets considerably less cash flow than the C-Corp when the S-Corp reimburses for income taxes. This is shown as follows:

From Company's View (assumes Company reimburses for income taxes)	Utility as a C-Corp	Utility as an S-Corp
Cash Flow to company (income after taxes plus depreciation)	$ 170,000	$ 170,000
Less: Dividend (assume 50% payout of earnings after taxes	(60,000)	(60,000)
Less: Payments to shareholders for reimbursement of income taxes		(42,000)
Net Cash Flow to Shareholder	$ 110,000	$ 68,000

The C-Corp's net cash flow is $110,000 while S-Corp's net cash flow is $68,000 – or $42,000 less. The S-Corp has considerably less cash flow for it to reinvest and grow.

A similar analysis can be made for sole proprietorships, limited liability companies ("LLCs"), and partnerships. The primary difference is that the income from these types of entities may be subject to self-employment taxes. Exhibit A, attached, includes an analysis for sole proprietorships, LLC's and partnerships as well as that for an S-Corp as discussed herein.

Choosing the Right Business Entity

There are advantages and disadvantages of each form of business entity. Exhibit B, attached hereto, contains a brief summary of each of the advantages and disadvantages of the business entities. Small business owners choose tax pass-through business entity forms for a variety of reasons. There is no question that investor's in tax pass-though entities avoid double taxation. This is probably the most cited reason for choosing this type of entity. Generally, the S-Corp or single member LLC will prove the best choice for single owner businesses, because double taxation is avoided. However, it is generally very difficult for a tax pass-though entity to reinvest its profits in the business because current profits are taxed to shareholders/owners whether they are distributed or not. Thus, when it is critical to retain the maximum amount of capital to finance growth, the C-Corp's lower graduated tax rates can make it the better choice.

The difficulty of reinvesting profits and accumulating capital associated with S-Corps and other pass-through entities may be minimized by the enhanced ability to attract capital. In the early years of starting a business, the business will have many expenses and losses. Smaller businesses are also more prone to losses as they are less diversified. These losses may be better used by the business owners rather than the business itself as losses can be offset against the other personal income of the business owners. A C-Corp would have the losses locked within the business and unavailable to take against the owners other personal income. Interestingly, a parent holding company of a C-Corp which files a consolidated return has the similar advantage of offsetting losses with other income as does an owner of a tax pass-though business.

EXHIBIT A

Analysis of Impacts of Income Taxes
Companies are assumed to be the same in every respect except for recovery of income taxes.

	Utility as a C-Corp	Utility as a S-Corp	Utility as a Sole Proprietorship LLC*, or Partnership
Rate Base	$ 1,200,000	$ 1,200,000	$ 1,200,000
Rate of Return (ROR)	10.00%	10.00%	10.00%
Required Operating Income	$ 120,000	$ 120,000	$ 120,000
Revenues	$ 345,440	$ 270,000	$ 270,000
Less: Allowed Operating Expenses	100,000	100,000	100,000
Depreciation	50,000	50,000	50,000
Income Taxes (assumes 38.6% state and federal effective tax rate)	75,440	-	-
Operating Income	$ 120,000	$ 120,000	$ 120,000
Earnings before Interest, Taxes, and Depreciation and Amortization (EBITDA) [1]	$ 245,440	$ 170,000	$ 170,000
Earnings before Interest and Taxes (EBIT) [2]	$ 195,440	$ 120,000	$ 120,000
Implied Value (assuming capitalization rate[3] for EBITDA is 14.5%)	$ 1,692,690	$ 1,172,415	$ 1,172,415
Implied Value (assuming capitalization rate[3] for EBIT is 11.5%)	$ 1,699,478	$ 1,043,480	$ 1,043,480
From Shareholder/Sole Proprietor/LLC Member/Partner View (assumes no reimbursement from Company for income taxes)			
Dividend/Distribution (assume 50% payout of earnings after taxes)	$ 60,000	$ 60,000	$ 60,000
Less: Dividend Tax (assume qualified dividend tax rate of 15%)	(9,000)	-	-
Less: *Personal Income Taxes (assume 35% state and federal effective tax rate)*[6]		(42,000) [6]	(42,000) [6]
Less: Self-employment Taxes (for sole proprietorship, LLC, and partnership)[7]			(16,723) [7]
Net CashFlow to Shareholder/Sole Proprietor/LLC Member/Partner	$ 51,000	$ 18,000	$ 1,277
Investor's net cash yield on investment[7]	4.25%	1.50%	0.11%
Difference in cash flow compared to C-Corp shareholder without reimbursement		$ (33,000)	$ (49,723)
From Shareholder/Sole Proprietor/LLC Member/Partner View (assumes a reimbursement from Company for income taxes)			
Dividend/Distribution (assume 50% payout of earnings after taxes)	$ 60,000	$ 60,000	$ 60,000
Less: Dividend Tax (assume qualified dividend tax rate of 15%)	(9,000)	-	-
Less: Personal Income Taxes (assume 35% state and federal effective tax rate)[6]		(42,000) [6]	(42,000) [6]
Less: Self-employment Taxes (for sole proprietorship, LLC, and partnership)[7]			(16,723) [7]
Plus: Reimbursement from Company for Income Taxes		42,000	42,000
Net CashFlow to Shareholder/Sole Proprietor/LLC Member/Partner	$ 51,000	$ 60,000	$ 43,277
Investor's net cash yield on investment[7]	4.25%	5.00%	3.61%
Difference in cash flow compared to C-Corp shareholder with reimbursement		$ 9,000	$ (7,723)
From Company's View (assumes Company reimburses for income taxes)			
Cash Flow to Company (Income after tax plus depreciation)	$ 170,000	$ 170,000	$ 170,000
Less: Dividend/Distribution (assume 50% payout of earnings after taxes)	(60,000)	(60,000)	(60,000)
Less: Payments to Owners for Income Taxes	-	(42,000)	(42,000)
Net Cash Flow to Company (that may be used for reinvestment)	$ 110,000	$ 68,000	$ 68,000
Difference to Company net cash flow compared to C-Corp with reimbursement		$ (42,000)	$ (42,000)
Company's net cash yield on investment[8]	9.17%	5.67%	5.67%

* Limited Liability Company (LLC) which elects to be treated as a partnership for tax purposes.

[1] EBITDA is essentially net income with interest, taxes, depreciation, and amortization added back to it, and can be used to analyze and compare profitability between companies and industries because it eliminates the effects of financing and accounting decisions.

[2] EBIT is all profits before taking into account interest payments and income taxes. An important factor contributing to the widespread use of EBIT is the way in which it nulls the effects of the different capital structures and tax rates used by different companies. By excluding both taxes and interest expenses, the figure hones in on the company's ability to profit and thus makes for easier cross-company comparisons.

[3] Capitalization rate (c) equals the cost of capital or discount rate (k) minus the expected growth rate (g) *for the benefit stream being employed.* Implied Value equals Benefit stream divided by Capitalization rate.

[4] Effective income tax rate could vary depending on level of taxable income. Income taxes computed on stand-alone basis.

[5] No taxble income at entity level. S-Corp, Sole Proprietorship, LLC, and Partnership does not pay income taxes. Taxable Income is passed through to owners.

[6] Effective income tax rate could vary depending on level of taxable income. Owners pay taxes on all the income from the utility and not just on dividends/distributions received.

[7] Pass-through income may be subject to up to 15.3% self-employment tax (12.4% for social security up to $106,800 for 2011, and 2.9% on all income) for sole proprietorship, LLC, and partnership. For 2011, the social security tax rate has been reduced to 10.4%.

[8] Assumes equity investment equals rate base.

Exhibit B

Advantages and Disadvantages of Business Entities

Sole Proprietorship

Advantages

- All business tax advantages flow through to owner
- Organizational costs are low
- Legal and Accounting fees and be low
- State and federal Taxes may be lower
- Administration is less complicated
- Easily converted to another entity

Disadvantages

- Personal liability
- Inability to income split
- Limited deductibility of fringe benefits
- Subject to self-employment tax

Partnership

Advantages

- Income is distributed to partners rather than to partnership
- Distributed income is not subject to double taxation
- Losses and credits generally passed through to partners
- Liability of limited partners is normally limited as in a corporation
- There can be more than one class of partnership interests
- Partners can obtain basis for partnership liabilities
- Special allocations are permitted

Disadvantages

- The liability of general partners is not limited
- Partners are taxed currently on earnings even if the earnings are not distributed
- General partners are subject to self-employment taxes
- Partners cannot include certain tax favored fringe benefits from their taxable income

- Partners may be required to file numerous state individual tax returns for multi-state partnerships
- In the absence of a business purpose, a partnership must use either a calendar year or the same year as the partners who own a majority interest in the partnership

Limited Liability Company

Advantages

- Similar advantages to limited partnership
- Special allocations available
- Good asset protection
- Separate legal entity
- No restriction on number of members
- Tax consequences flow through to members
- Members can employ managers
- Tax free liquidations
- Pass through of entity debt

Disadvantages

- Uncertainty of self-employment taxes
- May be restrictions to certain businesses and professions
- Potential additional taxes and filing fees
- Must use calendar year
- Cancellation of debt may stick to member
- Recourse and nonrecourse debt issues
- No at-risk amounts because of the limited liability of each member

Subchapter C Corporation

Advantages

- Ability to split income between itself and owner(s) with potentially lower overall tax rates as a result
- Best fringe benefits and retirement plans
- Can have unlimited number of owners
- Can adopt fiscal tax year
- Limited liability
- Multiple classes of equity

- Deduction for dividends received
- Consolidated returns
- Maximum corporate tax rates are now less than maximum individual tax rates

Disadvantages

- Subject to double taxation
- Must use accrual method of accounting
- Certain types of income such as interest, dividends, rents and royalties are potentially subject to the personal holding company tax on such income
- The difference between a "C" corporation's adjusted current earnings and its taxable income is mostly (75%) a tax preference item for purposes of the alternative minimum tax

Subchapter S Corporation

Advantages

- Single level of tax on earnings – no double taxation
- Limited liability
- Losses can be deducted by shareholders
- Can use cash method of accounting
- No alternative minimum tax issues
- Distributions generally tax free

Disadvantages

- Since there is no corporate tax rate, nonqualified deferred compensation plans are impractical
- There is no opportunity to accumulate earnings in a lower corporate tax bracket. It is difficult to reinvest profits in the business since current profits are taxed to shareholders whether they are distributed or not
- Split-dollar and other non-deductible fringe benefits for the shareholders cannot be paid for by lower taxed corporate funds
- The dividends received deduction is lost
- A new or dissent shareholder can cuase termination of the subchapter S election through a disqualified transfer of stock
- All income, except long-term capital gains, received by the corporation are taxable to the shareholder whether or not they are currently distributed
- Use of an S corporation results in a loss of lower tax bracket at the corporate rate level on the first $75,000 of income

Exhibit B

- There are restrictions on borrowings by S corporation shareholders from their qualified retirement plants
- If an S corporation shareholder is not a material participant, S corporation losses may only be deducted against passive losses
- More record keeping may be required because of the need to maintain accurate records for basis in shareholder stock, to maintain accumulated earnings adjustments accounts, and to determine the taxability of distributions.